# Supreme Court of the United States

October Term, 1945—No. 55.

UNITED STATES OF AMERICA and
FEDERAL COMMUNICATIONS COMMISSION,

*Appellants,*

*v.*

NEW YORK TELEPHONE COMPANY,

*Appellee.*

## BRIEF FOR NEW YORK TELEPHONE COMPANY, APPELLEE.

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## BRIEF FOR NEW YORK TELEPHONE COMPANY, APPELLEE.

### Opinion Below.

The opinion of the District Court for the Southern District of New York is reported in 56 F. Supp. 932 (1944).

### Jurisdiction.

The jurisdiction of the District Court was invoked pursuant to Section 402(a) of the Communications Act of 1934, 48 Stat. 1064, 1093, 47 U. S. Code §402(a). This section makes applicable to orders of the Federal Communications Commission (other than orders relating to radio station construction permits or licenses or radio operators' licenses) the provisions of the Urgent Deficiencies Act, 38 Stat. 219, 220, 28 U. S. C. §§41(28), 43-48, inclusive, which vest the District Courts with jurisdiction to entertain suits to enjoin the enforcement of orders of the Interstate Commerce Commission. Accounting orders of the Interstate Com-

merce Commission and the Federal Communications Commission are final orders affecting substantial rights which are proper subjects of suits under these Acts.

> *Kansas City Southern Railway Co.* v. *United States*, 231 U. S. 423 (1913);
> *Norfolk & Western Railway Co.* v. *United States*, 287 U. S. 134 (1932);
> *American Telephone & Telegraph Co.* v. *United States*, 299 U. S. 232 (1936).

The jurisdiction of this Court on appeal rests upon Section 238 of the Judicial Code, 28 U. S. C. §345(4), as affected by the above cited provisions of the Federal Communications Act.

## Statement of the Case.

This case differs radically from any previous case arising in the application of "original cost" accounting to public utility companies which had theretofore kept their accounts on a different basis. Previous cases have dealt with attempts by regulatory commissions to require adjustments in the accounts for the purpose of showing certain facts with respect to assets still in service. Here, although three-quarters of the assets involved have already been retired and written out of the company's accounts, the Commission has sought, by requiring adjustments in the surplus and depreciation reserve accounts, to treat these retired properties, in effect, as if they still existed.

In its effort to justify this, the Government completely misstates appellee's position. Appellee has not questioned the Commission's power to prescribe a new System of Accounts different from that theretofore prescribed or to require a reclassification of existing balances to conform

thereto. Appellee has not contended that such a reclassification would be retroactive, nor has it claimed a vested right in any previously prescribed accounting rules or entries. Appellee's position has been consistent; it is the position of the Commission which has changed.

The Commission's Order was based entirely on a finding (see pp. 19-22, *infra*) that the entries upon the acquisition of the properties in the 1920's were *erroneous when made*,—whether because in violation of the I. C. C.'s rules then effective or of the F. C. C.'s views retroactively applied, is not clear. Any assertion of power in the F. C. C. to make retroactive rules is now disclaimed by the Government and the claim of violation of the I. C. C.'s rules is not seriously argued. Thus the basis of the Order—that the original entries were erroneous and that the entries now ordered are in correction of those errors—no longer stands.

The Government now seeks to defend the Order on the ground that the Order merely requires a reclassification of appellee's accounts under the "original cost" provisions of the Commission's new System of Accounts. It does this despite the facts that the Commission's report expressly denies that such is the case (R., p. 36), and that the Order is itself contrary to the terms of the new System and is otherwise wholly inappropriate as a reclassification.

The Government also seeks to defend the Order on a ground entirely unrelated either to transactions between affiliates, original cost accounting or the Commission's new System of Accounts. This is the claim that, as the result of an alleged failure to accrue sufficient amounts in the depreciation reserve to retire the purchased property, there is now a deficiency in the reserve "at least" as large as the transfer from surplus to depreciation reserve required by the Order. No such issue was tried before the Commis-

sion and there is no evidence to support the Government's claims.

The Government also denies the applicability of the "binding construction" in the *A. T. & T.* case, which we urge as an independent ground for enjoining the Order.

The statutory court was unanimously of the opinion that the Order could not be supported on any of the grounds urged by the Government, and that the case required further consideration by the Commission. The statutory court, of course, left the Commission entirely free, on further hearing, to require a proper reclassification of appellee's accounts under the Commission's "original cost" system.

## The Facts.

The order of the Federal Communications Commission, the enforcement of which the District Court enjoined, directed the appellee, New York Telephone Company, to write off, by a charge to surplus, the sum of $4,166,510.57 (R., p. 41).* This was the amount by which the purchase price paid by the appellee for certain telephone plant purchased by it from American Telephone and Telegraph Company in the years 1925-1928 exceeded the amount

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* This order is sometimes hereinafter referred to as "the Order". The Federal Communications Commission will be generally referred to as "the Commission" or "the F. C. C.", the Interstate Commerce Commission as "the I. C. C.", New York Telephone Company as "the New York Company" or as "the appellee", and American Telephone and Telegraph Company as "the American Company".

References to the printed record in this Court are indicated as (R., p. ....). The parties have stipulated (R., p. 136) that the transcript of the hearings and the exhibits before the F. C. C. need not be printed. References to this transcript and these exhibits, as paged in the F. C. C.'s motion for summary judgment in the court below, are indicated as (Tr., p. ......) or by the appropriate exhibit numbers. References to the Appendix to this brief will be indicated as (A., p. .. ).

found by the F. C. C. to represent the net book cost* of such plant on the books of the American Company at the time of these purchases.

The F. C. C. directed this write-off in spite of the fact that, as found by the District Court (R., p. 129), the bulk of the property so purchased had already been retired and written off with a corresponding charge against depreciation reserve, so that, as of the effective date of the Order, only $3,241,865.52, or. less than 26% of the property originally purchased, remained in the appellee's property accounts (R., pp. 128-129). In other words, the write-off directed by the F. C. C. exceeded, by nearly a million dollars, the entire amount at which the purchased property remaining in service was recorded on the appellee's books on the effective date of the Order.

The United States and the F. C. C. now make no claim of overvaluation of these properties, and do not seriously argue that there was error in the original accounting. However, so many different grounds have been asserted at different times as justification for the action here taken that we believe it will be helpful briefly to set forth the facts as to these purchases and the appellee's accounting for them.

**1. The purchase of toll plant and instruments by the appellee from the American Company.**

For many years prior to 1925, due to certain historical reasons, both the American Company and the appellee had been engaged in furnishing intrastate toll service within the State of New York (Tr., pp. 78-81, 309, 515-523).

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* The term "net book cost" is defined in the Commission's report (R., p. 24) and will be used in this brief to mean "the book cost minus the amount of depreciation and amortization reserves shown on the books which is related to the property for which the book cost is shown".

In order to eliminate this overlap, the American Company agreed to transfer all of its New York intrastate toll business to the appellee. This was accomplished in three transfers, as of June 1, 1925, November 1, 1925 and September 1, 1926 (R., p. 121; Tr., pp. 78-81).

To handle the additional intrastate toll business so transferred, the appellee required considerable amounts of toll property. This it had either to construct or to acquire from the American Company. It was to the obvious interest of both parties that the plant thus needed by the appellee be purchased from the American Company, and the two companies agreed that this should be done. The purchase of the toll property by the appellee was made as of November 1, 1925 and September 1, 1926, the latter purchase being comparatively small in amount. As of December 31, 1928, another small amount of toll plant was purchased by the appellee from the American Company to handle certain interstate toll business which had been transferred by the American Company to the appellee (R., p. 121; Tr., pp. 1273-1274).

The two companies agreed that the purchase price for this toll plant should be an amount equal to its "structural value." "Structural value" was a term of art defined in the I. C. C.'s Uniform System of Accounts for Telephone Companies (Instruction 13) as "the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy." The structural value of the toll plant was determined by means of a field inspection and detailed appraisal described at length at the hearing before the F. C. C. (R., p. 122; Tr., pp. 84-86, 91, 109, 323-357, 418, 569-615, 623-662, 666-675, 766-828, 832-931, 1240-1273, 1276; Exs. 1, 16, 21 and 44; Tr., pp. 2167, 1154, 1156, 574-575,

2183). The structural value so determined and the resulting purchase price appear in the fourth column of the table on page 9 of the Government's Brief.

From the earliest days of telephony, the American Company, as holder of the fundamental Bell patents, had owned three parts of the telephone apparatus, which the appellee and other licensee companies were authorized to use. These parts, the transmitter, receiver and induction coil, known collectively as "the instruments," are an integral part of the telephone equipment placed upon the premises of subscribers, the rest of which (such as the stand, the bell box and the casing) was owned by the various licensee companies. The use and maintenance of the instruments were included among the services furnished by the American Company under a license contract, for which the licensee companies made specified payments (R., pp. 121-122; Tr., pp. 212, 530).

On December 31, 1927 the American Company sold to the appellee the instruments then in the latter's service or supplies. The purchase price was $6,661,238.91. This price was based upon the average price charged the American Company by Western Electric Company, the manufacturer of the instruments, during the first nine months of 1927, less an allowance of 20% to reflect their then condition. It was approved by qualified engineers of the appellee, after investigation, as a fair and reasonable price (R., p. 122; Tr., pp. 965-967, 1034; Exs. 19, 48, 51; Tr., pp. 1106-1107, 1105-1106, 2184-2185). Similar sales of instruments were made at the same time and on the same basis to all of the licensee companies of the American Company, including companies which were not controlled by the American Company (Tr., pp. 989-990).

This appeal presents no question of overvaluation of the property purchased by the appellee from the American Company. On the contrary, as is set forth in Finding of Fact X of the court below, which is not challenged by the appellants, "the defendant Federal Communications Commission in the proceeding before it resulting in its order dated December 14, 1943, * * * made no determination with respect to the value of any of the property purchased by the plaintiff from the American Company and counsel for the defendants in this action, upon oral argument, informed the Court that the Commission was not relying on any claim of overvaluation and that for the purposes of this action no such issue existed" (R., p. 122).

**2. The appellee's accounting for these purchases.**

Although the Government now takes the position (Government Brief, p. 37) that it is immaterial whether appellee's original accounting for these purchases was or was not erroneous, this represents, as will be shown hereafter (pp. 19-22, *infra*), a complete departure from the basis on which the Order was founded. For that reason it becomes important for the Court to have before it the facts concerning this accounting.

At the time of these purchases the appellee's accounting was regulated by the I. C. C., pursuant to Section 20 of the Interstate Commerce Act (24 Stat. 379, 386, as amended by the Acts of June 29, 1906, 34 Stat. 584, 593, 594 and of June 18, 1910, 36 Stat. 539, 555). By order dated December 10, 1912, the I. C. C. had adopted a "Uniform System of Accounts for Telephone Companies, First Issue", effective January 1, 1913. This System of Accounts, with minor amendments not here material, remained in effect until January 1, 1933, when the I. C. C.'s "Uniform

System of Accounts for Telephone Companies, First Revised Issue'' became effective (R., p. 122).

The provisions of the Uniform System of Accounts for Telephone Companies, First Issue, relating to the recording of property purchased were contained in Instructions 10 and 13. Instruction 10, a general instruction relating to all acquisitions, so far as here material, read as follows (R., pp. 122-123; A., p. 4):

> ''10. *Costs to be actual money costs.*—All charges made to fixed capital or other property accounts with respect to any property acquired on or after January 1, 1913, should be the actual money costs of the property. * * *''

Instruction 13 contained special instructions as to the accounting ''when any property in the form of a going or completed plant is purchased.'' This instruction, so far as here material, read as follows (R., p. 125; A., pp. 4-5):

> ''13. *Plant and equipment and other property purchased.*—When any property in the form of a going or completed plant is purchased, an appraisal of the property so acquired should be made, and the different constituent elements of the plant (and equipment, if any) or other property acquired *should be appraised at their structural value; that is to say, at the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy.* If the actual money value of the consideration given for the plant or other property was at the time of the acquisition in excess of such appraised value, the excess should be charged to account No. 204, 'Other Intangible Capital,' and the appraised value of the constituent elements should be charged to the appropriate fixed capital accounts as hereinafter designated. If the actual money

value of the consideration given was not in excess of such appraised value, such actual money value should be distributed through the said accounts in proportion to the said appraised value of the constituent elements appropriate to the respective accounts. * * *" (Italics ours.)

In its Accounting Bulletin No. 11 issued June 26, 1916, the I. C. C. defined the scope of the transactions to which Instruction 13 applied, as follows (R., pp. 123-124):

"Case No. 30.

"Query. What items should be classified as 'going or completed plant' under section 13, page 33, 'Plant and equipment and other property purchased' of the Uniform System of Accounts for Class A and B companies?

"Answer. The term 'going or completed plant' is intended to cover only the entire plant of a telephone company or an important unit thereof; such as—

"(1) A telephone company as a whole,

(2) An entire central office,

(3) A system of lines and stations within a given area, or

(4) A complete section of toll plant. * * *"

It is to be noted that none of these instructions drew any distinction between cases where the acquisition was from an affiliated company and cases where the acquisition was from a stranger.

The appellee's acquisitions of toll plant from the American Company clearly constituted the acquisition of "a complete section of toll plant" as set forth in subdivision (4) of Case No. 30 of the I. C. C.'s Accounting Bulletin No. 11. Accordingly, the accounting for these

purchases was governed by Instruction 13 of the I. C. C.'s Uniform System of Accounts which required that the property be recorded in the plant accounts at structural value determined by appraisal, not, however, in excess of the amount paid. Since the amount paid by the appellee for the toll plant was the appraised structural value of the plant, the purchase price of $5,973,441.47 was distributed, in accordance with Instruction 13, among the various plant accounts, such as pole lines, aerial wire, etc., in the precise amount of the appraised structural value of the various types of property purchased (R., p. 124; Tr., 115-116).

In accounting for the purchase of the instruments, the appellee again turned to Case No. 30 in Accounting Bulletin 11 to determine whether or not this transaction was subject to Instruction 13. It determined that the instruments did *not* comprise "the entire plant of a telephone company or an important unit thereof," to which alone, as set forth in Case No. 30, Instruction 13, with its requirement of appraisal, was applicable. The controlling instruction was therefore Instruction 10 which directed that charges should be made to fixed capital or other property accounts in the amount of the actual money cost of the property. The instruments were therefore recorded in the appropriate accounts at their actual money cost, to wit, $6,661,238.91 (R., p. 124; Tr., p. 483).

So much for the accounting performed at the time of the purchases. Now let us turn to the depreciation accounting subsequently performed.

This likewise was regulated by the I. C. C.'s accounting rules. The so-called "group method," which both the I. C. C. and later the F. C. C. itself prescribed for telephone company depreciation accounting, recognizes that it would be wholly impracticable for a company which employs a

Tr., pp. 1279-1301, 1421-1438, 1322, 2163, 2185). The District Court found that of the $12,634,680.38 of property originally purchased by the appellee from the American Company, only $3,241,865.52 remained in appellee's plant accounts on December 31, 1941 (R., pp. 128-129).*

### 3. The background and nature of this proceeding.

The Communications Act of 1934 vested in the F. C. C. the right (Sec. 220(a)) to "prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to this Act . . ." The facts in regard to the Uniform System of Accounts embodying "original cost" accounting promulgated by the F. C. C. under this authority, the litigation culminating in the decision of this Court in *American Telephone & Telegraph Co.* v. *United States*, 299 U. S. 232 (1936), and the appellee's reclassification of its accounts, are sufficiently set forth in the Government's Brief (pp. 12-15).

That Brief (pp. 15-16) likewise sufficiently describes the proceedings before the Commission resulting in the Order here in question. As to the *basis* upon which the Commission founded the Order, however, we request the Court, for reasons which will hereafter appear (pp. 19-22, *infra*), to study the full text of the Commission's report (R., pp. 21-40) rather than the characterization of it on page 17 of the Government's brief.

Upon the coming down of the Order, the appellee brought this suit in the District Court for the Southern District of New York to enjoin its enforcement (R., pp.

* Fifty-seven per cent of the property purchased had been retired and written off even before January 1, 1937 (the effective date of the F. C. C.'s System of Accounts). Of the $12,634,680.38 of property included in the original purchase, only $5,404,164.40 remained in appellee's accounts at January 1, 1937 (Exs. 58, 62, 67; Tr., pp. 1322, 2163, 2185).

1-20). The appellants moved for summary judgment on the record made before the Commission (R., pp. 57-65), and it was agreed among counsel for the parties that upon the determination of this motion final judgment might be entered in favor of the party in whose favor said motion should be decided (R., p. 120).

On August 24, 1944, the District Court (Swan, C. J., and Clancy and Bright, D. J.) handed down its unanimous opinion (R., pp. 108-118) denying the appellants' motion for summary judgment. The District Court held that the accounting followed by the appellee at the time of and after the acquisition of the toll plant and instruments was in conformity with the rules of the I. C. C.; that the F. C. C. cannot apply a new system retroactively so that entries that were proper when made now become erroneous; and further that, under the administrative construction of the F. C. C.'s System of Accounts made by the Commission in the *A. T. & T.* case, the mere fact that property had been purchased by the appellee at a price in excess of the then net book cost of the American Company did not justify the F. C. C.'s now directing the appellee to write off the entire amount of such excess to surplus.

Pursuant to the above-mentioned agreement of counsel, final judgment permanently enjoining the enforcement of the Federal Communications Commission's order was entered by the District Court (R., pp. 118-119).

## Outline of Argument.

The appellants, ignoring the settled rule that an administrative order cannot be upheld unless the grounds upon which the agency acted were those upon which its action can be sustained, seek in their Brief in this Court to justify the Order upon a basis entirely different from

that on which it was founded by the F. C. C. The F. C. C. based the Order, as we shall show, upon alleged errors in the original entries. This ground is now ignored and the Government seeks to defend the Order on entirely different grounds, the principal one of which, to wit, the claim that the Order is simply a reclassification under the F. C. C.'s System of "original cost" accounting, was directly repudiated in the F. C. C.'s report (R., p. 36).

The Government seeks to place the appellee in the position of contending that the F. C. C. had no authority to require a restatement of the accounts with respect to transactions which took place before the Commission was in existence, and of claiming (Government Brief, p. 38) a "vested right in the system of accounting which prevailed at the time a particular transaction took place." The appellee does not make and has never made any such contention.

On the other hand, this conceded premise that the F. C. C. is not precluded from requiring a reclassification of accounts simply because the transaction from which these accounts result was properly recorded under a previous accounting system, certainly does not lead to the conclusion that the F. C. C. can make any order with respect to such past transactions that it pleases. Specifically, this premise does not support a conclusion that when three-fourths of the property involved in a past transaction has already been retired and written off, the F. C. C. can require the same write-off as if all the property were still in existence. Neither does the premise support a conclusion that the F. C. C., by virtue of what the Government now calls a reclassification order, may require a telephone company to add to an admittedly adequate depreciation reserve an amount, in this case $3,879,957.94, actually larger than the cost of all of the property not already retired.

This gap between premise and conclusion, which the Government jumps so easily in its brief, did not seem so easy to the F. C. C.'s staff or to the F. C. C. itself. The F. C. C.'s staff realized that their desire to secure a write-off to surplus equal to the excess of the purchase price paid by the New York Company over the American Company's net book cost could not be fulfilled through a reclassification of the existing balances to conform with the F. C. C.'s System of Accounts since the *entire balance* remaining from the purchases was less than the desired write-off. They realized also that an attempt to construe the F. C. C.'s System of Accounts as requiring reclassification under "original cost" accounting with respect to *retired* property would be wholly irrational and would be inconsistent with the Government's own professions in the *A. T. & T.* case (see pp. 33-34, *infra*) that in applying the new system of "original cost" accounting "property retired since acquisition is not involved."

The theory which the F. C. C.'s staff developed to accomplish their purpose was that appellee's *original accounting* had been erroneous. On this view, the F. C. C. would not be requiring a "reclassification" under which it would meet the objection that the accounts could not be reclassified as to property already retired, but merely a "correction" which should have been made even if the F. C. C.'s System of Accounts had never taken effect.

The appellee countered with two contentions: *first*, that its original accounting was not erroneous and, *second*, that even if it were, such an error would not justify a correction in respect of property already removed from the books. The F. C. C. sustained its staff's contention that the original accounting was erroneous (R., pp. 28-29). Its report is not altogether clear as to whether it reached this result on the basis that the original accounting transgressed

the I. C. C.'s rules (R., pp. 32-34) or, as we think, on the ground that the original accounting violated the F. C. C.'s views retroactively applied (R., pp. 28-30); but that the Order was founded upon the premise that the original accounting was erroneous is clear beyond doubt. The Commission said unequivocally (R., p. 36) that "the entries made at the time of the four property transfers involved herein were improper" and that appellee "should have eliminated them and corrected its books *before reclassifying its accounts in 1937.*" (Italics supplied.) The Commission also rejected appellee's contention that if there had been an error in the original accounting, this error could be corrected only as to property still in existence. It made no attempt to sustain the Order as a reclassification, independent of the correctness of the original accounting.

In its brief in the District Court, and still more so in its brief in this Court, the Government has departed from this theory on which the F. C. C.'s Order was based. It says (Government Brief, p. 37) that a ruling by this Court on the question of compliance or non-compliance of the original accounting with the I. C. C.'s rules is not essential, and no question as to the correctness of the original entries is seriously pressed. Instead, the Government argues, *first,* that the Commission's order can be sustained as a reclassification under the "original cost" provisions of the Commission's Uniform System of Accounts (Government Brief, Point II), and, *second,* that, insofar as it goes beyond the proper scope of reclassification, it can be sustained as requiring rectification of a deficiency in appellee's depreciation reserve (Government Brief, Point III).

The Government's position must be rejected, *first,* because it is not the ground on which the Commission in fact proceeded and, *second,* because if the Commission had pro-

ceeded on this ground, its action would have been without warrant.

In Point I of this brief we will show that the District Court correctly set aside the Order because the Order cannot be sustained on the ground of error in the original accounting on which the Commission based it. The only lawful test of the correctness of the appellee's accounting for these purchases was whether or not it complied with the requirements laid down by the I. C. C. The District Court was plainly right in holding that the accounting did so comply. Since the Order cannot be sustained on the ground on which it was made, it is quite immaterial whether, as the Government now urges, the Order could be sustained on some other ground on which the F. C. C. did not in fact proceed.

In Point II of this brief we will deal with the entirely different theories upon which the Government seeks to sustain the Order in this Court, namely, that regardless of the propriety of the original accounting the F. C. C. may nevertheless, by virtue of its power to order a reclassification under "original cost" accounting of the balances existing on the effective date of its System of Accounts, or otherwise, require precisely the same write-off as it in fact required in pursuance of its theory of error in the original accounting. The Order cannot be sustained as a reclassification to an original cost basis, since this is not what the Order purports to be and since such a reclassification order, by its very nature, cannot deal with property already retired. Neither can the Order be sustained as requiring rectification of appellee's depreciation reserve, since no such issue was tried before the Commission, there is not the slightest evidence to support the Government's claims, and the Government's position involves a complete depar-

ture from the principles of depreciation accounting prescribed both by the I. C. C. and the F. C. C.

Finally, we shall show in Point III of this brief that the District Court would have been justified in enjoining enforcement of the Order upon the independent ground that it constitutes a flagrant violation of the "binding construction" of the F. C. C.'s Uniform System of Accounts which this Court demanded of the Government in the *A. T. & T.* case.

## ARGUMENT.

### POINT I.

**The Commission's Order was properly enjoined for the reason that it was based upon the premise that the entries made at the time of acquisition of the properties were erroneous and this premise cannot be sustained.**

**A. The Order was founded upon the premise that appellee's entries made at the time of acquisition of the properties were erroneous.**

In analyzing the F. C. C.'s report and Order, the Court should have clearly in mind the drastic nature of the action which the Commission's staff was urging it to take. The staff desired the Commission to direct the New York Company to charge its surplus with $4,166,510.57, and to increase its depreciation reserve by a credit of $3,879,957.94, in spite of the fact that, of the entire $12,634,680.38 of property purchased in the 1920's, only $3,241,865.52, or approximately one-fourth, remained upon the books of the New York Company as of the date when the Order was to take effect. Whatever write-offs might or might not have been ordered

in respect of this *surviving* property pursuant to the Commission's power to require the existing balances to be reclassified to an "original cost" basis under its System of Accounts, it must have been obvious that these relatively small remaining balances would not support charges to surplus or credits to depreciation reserve of any such magnitude as the F. C. C.'s staff was urging the Commission to direct.

It was in recognition of these difficulties, as well as in a desire to outflank the stipulation in the *A. T. & T.* case (see p. 57, *infra*), that the F. C. C.'s staff developed a theory *that would go back of the balances remaining on the appellee's books.* Their endeavor was to convince the Commission, as a basic premise, that the *original entries* for these purchases were erroneous. To be sure, once this was done it was also necessary to persuade the Commission, as a second step in the argument, that, in spite of the lapse of nearly twenty years and the depreciation and retirement accounting that had been carried on during them, the Commission might now direct substantially the same action as would have been appropriate to correct such an "error" if the "error" had been discovered immediately after the original entries had been made; and this claim was likewise sustained in the Commission's report (R., p. 35). However, the first step in the argument, namely, that the original entries were erroneous, was basic.

This claim of error in the entries made when the properties were first acquired dominated the entire proceedings before the F. C. C. Indeed, if this had *not* been regarded as the issue, the largest part of the testimony which the appellee was permitted to introduce and also of the tes-

timony offered by the Commission's staff would have been wholly irrelevant.*

Although the Government now makes very light of the question of the correctness or incorrectness of the original accounting, the Commission did not do so. The F. C. C.'s report makes it perfectly clear that its entire reasoning was predicated upon acceptance of its staff's contention that the original accounting was erroneous. The report states that "the accounting performed by New York with respect to the four property transfers involved herein was improper" (R., p. 28); that "the passage of time can lend no sanction to improper accounting" (R., p. 29); that "whenever errors in accounting are discovered they should be corrected" (R., p. 29); that the entries made by the appellee "should never have been recorded in New York's accounts" (R., p. 29); and that "since the entries made at the time of the four property transfers involved herein were improper New York should have eliminated them and corrected its books before reclassifying its accounts in 1937" (R., p. 36).

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* For example, the appellee introduced testimony pursuant to specific permission of the F. C. C. (Tr., pp. 317-318) to show that it had accounted for the purchased property in accordance with Instructions 10 and 13 of the I. C. C. system of accounts (Tr., pp. 115, 116, 124, 84-86, 91, 109, 323-357, 418, 569-615, 623-662, 666-675, 766-828, 832-931, 1240-1273, 1276, 965-967, 1034, Exs. 1, 16, 19, 21, 44, 48, 51, Tr., pp. 1106-1107, 1105-1106, 2184-2185). The F. C. C. countered with extensive evidence intended to prove the contrary (Tr., pp. 680-714, Exs. 26-39, Tr., pp. 690-706, 1178-1224, 1613-1619, Exs. 71-78, Tr., pp. 1615, 1618, 1619, 1188-1198, 1603-1613, 1165-1178). The Commission also adduced testimony on the issue of whether the entries originally made by the appellee were consistent with fundamental principles of accounting outside of the prescribed I. C. C.'s system of accounts (Tr., pp. 1590-1603, 1624-1711, 1716-1734, 1772-1784, 1603-1623, 1165-1178, 1554-1590, 1933-1957, 1958-1990, 1990-2007, 2012-2017, 2022-2136). The appellee introduced rebuttal testimony both as to the I. C. C. rules and as to the fundamental principles of accounting generally accepted at the time of the purchases in question (Tr., pp. 445-465, 1345-1382, 725-755, 1711-1715, 1438-1481, Exs. 39-43, Tr., pp. 690, 706).

The Commission placed the basis of its action beyond all possible doubt when it stated that (R., p. 36):

> "The part played by the new Uniform System of Accounts effective in 1937, and the reclassification requirements thereunder, was simply to call attention to an impropriety in accounts which should have been corrected *even if the new system had not gone into effect.*" (Italics supplied.)

We will now show that this basic premise of the Commission's reasoning was unfounded.

**B. The F. C. C.'s proposition of error in the entries made at the time of acquisition of the properties cannot be sustained.**

In our brief in the lower court we showed in some detail that the proposition of error in the original entries upon which the F. C. C.'s Order was premised could not be sustained. Since the Government now makes no substantial contention to the contrary, it is unnecessary to burden the Court with extended argument upon this issue. However, in view of certain innuendoes in the Government's Brief and the fact that the Government's fifth assignment of error (R., p. 132)* has not been formally abandoned, a few words must be said in order to make the position entirely clear.

While the F. C. C. clearly based its report upon the premise of error in the original accounting, it seemed to assert at the same time that it could determine the correctness of that accounting upon the basis of its own views retroactively applied and without reference to the I. C. C.'s

* This assignment is that "the Court erred in its determination that the accounting entries here involved were made in compliance with then applicable rules and regulations of the Interstate Commerce Commission."

accounting rules in effect when the entries were made. We urged the lower court that if this was the correct reading of the report, the Order must be set aside on that ground alone, since under the doctrine of *Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Ry. Co.*, 284 U. S. 370 (1932), the I. C. C.'s rules constituted the only lawful standard for determining the propriety of appellee's conduct at the time. The occasion for the lower court's citation of the *Arizona Grocery Company* case, which the Government (pp. 39-41) now professes such difficulty in understanding, was, of course, this fact that while the F. C. C. rested its action upon the basis of the alleged unlawfulness of appellee's past conduct, it refused at the same time to judge the lawfulness of that conduct solely by the rules then in effect.

We showed alternatively in our presentation in the District Court that the appellee's accounting for these transactions conformed with the I. C. C.'s accounting rules. That appellee's accounting conformed with the language of these accounting rules appears sufficiently from what has appeared in our statement of the facts (pp. 8-11, *supra*). Any contention that these rules should be read as inapplicable to transactions between affiliates flies in the face of the general and comprehensive language used by the I. C. C. in regulating an industry where a very large proportion of the total transactions was well known to be between affiliates. Moreover, if the proper interpretation of these rules were doubtful in the slightest degree, which it is not, the history of the I. C. C.'s accounting rules and its *rejection* of "original cost" accounting shows conclusively that the rules meant exactly what they said.

The I. C. C.'s Uniform System of Accounts for Telephone Companies, as issued in 1912, following the

precedent of its accounts for railroads,* based its requirements for acquisition accounting upon cost to the accounting company.** The whole concept of "original cost" accounting not only was utterly foreign to the I. C. C.'s System of Accounts but was specifically rejected by the I. C. C., and this in the case of acquisitions from affiliated companies as well as in the case of acquisitions from independent companies.

Although the I. C. C.'s System of Accounts was promulgated in 1912, the entire theory of requiring a public utility to record, not its own costs of acquisition, but the net costs appearing on the books of a vendor, was not even advocated until the 1920's, and was not widely held until the early 1930's. It was then repeatedly urged upon the I. C. C. by various state commissions, but the I. C. C. declined to adopt it (Tr., pp. 1557-1559, 1658, 1977-1978, 1933).*** When the I. C. C. revised its Uniform System of Accounts for Telephone Companies effective January 1, 1933, it reaffirmed its adherence to the principle of cost to the accounting com-

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* See Interstate Commerce Commission Classification of Expenditures for Road and Equipment, First Revised Issue, effective July 1, 1907, and supplement effective July 1, 1908.

** In *Depreciation Charges of Telephone Companies*, 177 I. C. C. 351, 376 (1931), the I. C. C. said:

> "A general principle which has been followed in our classifications is that units of physical property shall be stated in the investment account *at cost to the accounting carrier.*" (Italics ours.)

*** The testimony of Mr. M. F. Orton, Director of Research and Valuation of the New York Public Service Commission, on this point merits quotation (Tr., p. 1978):

> "Q. What were the efforts to do? A. To have the Interstate Commerce Commission adopt a system which would reflect the original cost, in the case of all property, *whether acquired from related interests or at arms-length.*
>
> "Q. There were continued efforts to do that? A. Starting in 1930.
>
> "Q. And the Interstate Commerce Commission refused to do that? A. That is correct." (Italics supplied.)

pany—again without distinction between acquisitions from affiliated companies and acquisitions from others than affiliates (A., pp. 7-8).

To be sure, the I. C. C. realized that this general principle of cost to the accounting company required supplementation to prevent the recording of excessive or "inflated" amounts in the plant accounts. For that reason when it promulgated its System of Accounts in 1912, it provided for the segregation of the cost of telephone plant *in excess of the physical value.* Instruction 13 (*supra*, pp. 9-10) specified that, on any purchase of property "in the form of a going or completed plant," an appraisal must be made and any excess of purchase price over appraisal must be recorded in account 204, "Other Intangible Capital," against which no depreciation charges were permitted. In other words, the I. C. C.'s concern was not with excess of cost to the accounting company over *net book cost to the vendor,* which it regarded as irrelevant, but with excess of cost to the accounting company over *structural value at the date of acquisition.* This structural value safeguard was as applicable to a purchase from an affiliated company as to a purchase from a company not so affiliated.

In *Accounting Rules for Telephone Companies,* 203 I. C. C. 13, 43 (1934), the I. C. C. rejected a recommendation of the state commissions that its Uniform System of Accounts for Telephone Companies, First Revised Issue, should provide that, in all purchases of property previously used in telephone service, the property should be entered in the plant accounts on the basis of original cost to the company first devoting the property to the public service. It did this *specifically on the ground that changes in the price of capital assets due to changes in the price level ought to be recognized in the plant accounts and not eliminated from them as the state commissions urged.* It said (at page 43):

"While other considerations may affect the price to be paid for telephone plant purchased, it is fair to assume that the parties would have in mind as one of the elements the residual value of the various items *stated in terms of the current price level.* At any rate that is what the vendor parts with and what the vendee acquires so far as tangibles are concerned." (Italics supplied)

Our presentation on this subject in the lower court must have been convincing even to the Government, for in its brief in the District Court, while making a polite bow in the direction of the F. C. C.'s theory of error in the original accounting, the Government placed its principal reliance on other grounds. In its brief in this Court the Government does not seriously challenge the finding of the District Court that:

"The accounting entries made by plaintiff with respect to the toll plant and instruments purchased by it from the American Company from the time of their acquisition until January 1, 1937 were made in conformity with the rules which had been prescribed by the Interstate Commerce Commission and which were in effect during that period." (R., p. 129)

It says merely (Government Brief, p. 37) that it "does not consider a ruling on this point essential to the proper disposition of the case."*

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* Although the Government does not contend that the accounting was otherwise than in conformity with the I. C. C.'s rules, it does state (Government Brief, p. 36) that:

"The accounting for the specific transactions in question, however, was never submitted to the Interstate Commerce Commission for ruling, nor was any ruling ever made by the Interstate Commerce Commission with respect to the accounting therefor."

Since the accounting was clearly in accordance with formally promulgated rules of the I. C. C., there was no more occasion to submit

**C. Since the proposition of error in the entries made at the time of acquisition of the properties cannot be sustained, the Order was properly enjoined.**

We therefore think the Government was right when it decided to make no attempt to argue in this Court that appellee's original accounting entries were erroneous. But it is wrong when it takes the position that although the original accounting was correct, the Order can nevertheless be sustained. For an administrative order, as distinguished from a determination of a lower court, "can-

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these transactions for a ruling than any one of hundreds of others. Moreover, (1) these transactions were reflected in the annual reports filed both by the American Company and the New York Company with the Commission (Exs. 71-78, Tr., pp. 1615, 1618, 1619); (2) purchases of instruments similar to that made by the New York Company were made at the same time and on the same basis by all licensees of the American Company throughout the country, a transaction which naturally attracted wide attention on the part of persons dealing with telephony (Tr., pp. 989-990); and (3) both the instrument and toll plant transactions were specifically brought to the I. C. C.'s attention by Dr. M. R. Maltbie (Chairman of the New York Public Service Commission since 1931) in support of his argument for the adoption of original cost accounting by the I. C. C. in *Depreciation Charges of Telephone Companies* (1928), and *Accounting Rules for Telephone Companies* (1933), I. C. C. Dockets 14,700 and 25,705 (Tr., pp. 1992-1993, and Ex. 68 *id.*, Tr., pp. 1482, 1487, 2186).

Reference is also made in a footnote on pages 36-37 of the Government's Brief to various requests made by Bell System companies of the I. C. C. in cases where *the vendor's net book cost was the consideration actually paid,* for "rulings that it was proper to account for acquisitions of the type involved here by transferring the book figures of the transferor to the books of the transferee". The request was not for permission to record the acquisition upon any basis other than cost to the accounting company but simply for exemption from the necessity of obtaining an appraisal. The very fact that *permission* was deemed necessary to handle the transaction on the basis of the vendor's net book cost, even when this was the purchase price, is the plainest indication that the rules did not *require* the transaction to be so handled. Indeed, the I. C. C. specifically declined to issue any "general order" allowing any deviation from the requirement of appraisal and determination of structural value (Ex. 31; Tr., pp. 690, 706).

not be upheld unless the grounds upon which the agency acted in exercising its powers were those upon which its action can be sustained." *Securities and Exchange Commission v. Chenery Corp.*, 318 U. S. 80, 95 (1943). See, to the same effect, *Commissioner v. Heininger*, 320 U. S. 467 (1943), and *Eastern-Central Motor Carriers Association v. United States*, 321 U. S. 194 (1944).

As shown above (pp. 19-22), the Commission, for reasons which seemed compelling to it, placed its action squarely upon the ground of error in the original accounting. It went so far as to say (R., p. 36) that

> "Since the entries made at the time of the four property transfers involved herein were improper, New York should have eliminated them and corrected its books before reclassifying its accounts in 1937. The part played by the new Uniform System of Accounts effective in 1937, and the reclassification requirements thereunder, was simply to call attention to an impropriety in accounts which should have been corrected even if the new system had not gone into effect."

In the face of this clear language of the Commission, it is simply impossible to sustain the Order, as the Government now seeks to do, as one properly made *under* "the new Uniform System of Accounts effective in 1937, and the reclassification requirements thereunder," and *regardless* of the question of error or lack of error in the original accounting.

The Government will doubtless point to certain remarks in the F. C. C.'s report from which it may be argued that the Commission would have reached the same result if it had not reasoned from the erroneous premise that the original accounting was wrong. This is not enough. When an administrative agency has founded its determination on a basis on

which it cannot lawfully proceed, its order cannot be sustained on the basis of inferences, sought to be spelled out from passages in its report, that perhaps it might have reached the same result on other grounds. The statement by Mr. Justice Cardozo in *United States* v. *Chicago, Milwaukee, St. Paul & Pacific R. Co.*, 294 U. S. 499, 510 (1935), is applicable here:

> "We would not be understood as saying that there do not lurk in this report phrases or sentences suggestive of a different meaning. * * * The difficulty is that it [the Interstate Commerce Commission] has not said so with the simplicity and clearness through which a halting impression ripens into reasonable certitude. In the end we are left to spell out, to argue, to choose between conflicting inferences. Something more precise is requisite in the quasi-jurisdictional findings of an administrative agency. *Beaumont, S. L. & W. Ry. Co.* v. *United States*, 282 U. S. 74, 86; *Florida* v. *United States*, 282 U. S. 194, 215. We must know what a decision means before the duty becomes ours to say whether it is right or wrong."

See also *Connecticut Light & Power Co.* v. *Federal Power Commission*, 324 U. S. 515, 532-35 (1945).

If the original entries were correct, as they are now practically conceded to be, it is not simply to be *assumed* that the F. C. C., in the exercise of its power to require reclassification to accord with its new Uniform System of Accounts, would have ordered the appellee to make precisely the same charge to surplus as it in fact directed on the basis of an erroneous belief that the entries regarding these acquisitions were wrong in their inception, and on the theory that its "new Uniform System of Accounts . . ., and the reclassification requirements thereunder" were in no

way involved. The question of what changes the F. C. C. would direct in appellee's accounts, once it has been definitively ruled that appellee's original accounting was not erroneous, is a question that it and only it can determine. That question cannot be determined for it by Government counsel, or even by this Court.

## POINT II.

**Even if the Government might be heard to support the Commission's Order on grounds different from those upon which the Order was based, the Order cannot be sustained.**

The Government's contention in this Court is that even though the original accounting was proper under the accounting rules applicable at the time, the Order can nevertheless be sustained as an exercise of the Commission's power to require the *balances* existing in the various accounts to be reclassified in conformity with the new System of Accounts prescribed by it. We will now show that even if the Commission's report could be read as based upon any such ground as this, the Order cannot be sustained.

We wish to emphasize at the outset that, whatever inferences to the contrary might be drawn from Point II of the Government's Brief, the appellee has never claimed and does not now claim any vested right in any of its book entries. We do *not* argue that because accounting was properly carried on under applicable regulation, the balances resulting from such accounting must remain in the same form to the end of time. We do *not* claim that simply because the I. C. C. permitted an excess of the purchase price of property over the seller's cost to be recorded in the plant accounts, the F. C. C. must allow it to remain there.

We concede that either the I. C. C. or the F. C. C. as its successor could require the balances remaining in appellee's property accounts to be reclassified to conform to a new system promulgated in accordance with law. Such a reclassification must, however, be a real reclassification in the light of the facts and of the actual rules of the new system.

That is all that the F. C. C. has been given power to do. Its authority under the Communications Act of 1934 is, *first*, to prescribe a system of accounts (§ 220(a)), *second*, to alter any such system on at least six months' notice, and, *third*, to police the system of accounts so prescribed (§ 220(g)). In other words, while Congress gave the Commission full and complete authority to enforce any system of accounts which the Commission lawfully prescribed, it did not empower the Commission to require revisions in past accounting *simply as such*.

In Point II of its Brief, the Government seeks to sustain the Order on the ground that it "merely requires appellee to restate its accounts prospectively in accordance with the Commission's original cost system of accounts" (Government Brief, p. 41). Apart from the point already made, namely, that this was not the basis on which the F. C. C. in fact proceeded, the answer to this contention is that this is not what the Order purports to do. For it applies not only to property still in appellee's property accounts, the only proper subject for reclassification under "original cost" accounting, but to property long since retired. In order to show that the F. C. C. had authority to make not merely *some* order but *this* order, the Government is thus forced to rely upon a further contention set forth in Point III of its brief, namely, that, insofar as the Order goes beyond a reclassification of existing balances in

the property accounts, it may be sustained as requiring rectification of a deficiency in the appellee's depreciation reserve.

The Order cannot be sustained on either of these grounds. It cannot be sustained on the ground urged in Point II of the Government's Brief, as requiring a reclassification of the balances in appellee's accounts to conform to the "original cost" provisions of the F. C. C.'s System, because it does not purport to be such an order and is not appropriate to that end. And it cannot be sustained on the ground advanced in Point III of the Brief, as requiring a rectification of appellee's depreciation reserve, because no issue as to the adequacy of the reserve was tendered by the order initiating the proceeding and there is no evidence to show any need for such rectification.

**A. The Order cannot be sustained as a reclassification under the original cost provisions of the F. C. C.'s System of Accounts of the balances existing on the effective date of that System, since its provisions are not appropriate to that end.**

A reclassification of the appellee's accounts to bring them into conformity with the F. C. C.'s principle of "original cost" accounting is necessarily limited to the balances existing in the various property accounts at the date as of which the proposed reclassification is made. The entire purpose of "original cost" accounting is to show the cost of the property now in public service at the time when it was first dedicated to that end, and to show separately the sums by which the price paid by the present owner for such property exceeded that original cost less the reserve requirements of the accounting company. This purpose is carried out by requiring the company to record

in one account (under the F. C. C.'s System, Account 100:1, *Telephone Plant in Service*) "the original cost [at the date of initial dedication to the public use] of the company's property used in telephone service at the date of the balance sheet * * *," and in a separate account (under the F. C. C.'s System, Account 100:4, *Telephone Plant Acquisition Adjustment*), the difference between the amount of money actually paid by the accounting company for such plant and the original cost of the property when first dedicated to the public use "less the amounts of reserve requirements for depreciation and amortization of the property acquired." It is obviously impossible to require the recording in the investment Account 100:4 of amounts paid in respect of property which, having been retired, is no longer an investment at all.

The F. C. C. is clearly on record to the effect that a reclassification to an "original cost" basis must necessarily be confined to property still on the books of the accounting company.

It stated in its brief in this Court in the *A. T. & T.* case (pp. 28-29) that the effect of its new System was merely to require "that the total amount in Account 100 of the present System* as of the effective date of the new system of accounts, shall be analyzed and then reclassified in the four new investment accounts as above numbered and named." ~~And in its reply brief in the *A. T. & T.* case before~~ the District Court (p. 88), it said:

> "Let us make the point clear that it is the original cost of that property *now used in telephone service, and of that property only* which it is necessary to

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* The instructions for this account, entitled "Telephone plant", provided:

> "This account shall include the company's investment in property used or held under a definite plan for telephone service * * *."

determine and record. Property retired since acquisition is not involved." [Italics in original.]*

As against this, the F. C. C.'s Order in this case was in no sense designed to compel appellee to determine "the original cost of that property now used in telephone service." Instead it represented an attempt by the F. C. C. to reach back of "the effective date of the new system of accounts" and to revise *ab initio* the entire accounting for all of the property acquired by the appellee from the American Company, including "property retired since acquisition."

In view of the F. C. C.'s own statement already quoted (p. 28, *supra*) that the only part played by its System of Accounts and the reclassification requirements thereunder was "to call attention to an impropriety in accounts which should have been corrected even if the new system had not gone into effect," it is unnecessary to indulge in extended argument to show that the F. C. C.'s order did not purport to be and was not one reclassifying the balances in appellee's accounts. However, if the F. C. C.'s report permitted any doubt upon this point, which it does not, that doubt would be completely dispelled by contrasting what would have been the approach if the F. C. C. had really been reviewing the reclassification of accounts made by the appellee subsequent to this Court's decision in the *A. T. & T.* case, with what the F. C. C. actually did.

In making its reclassification with respect to the toll plant, the appellee first ascertained the book cost of such of the plant as remained in service on January 1, 1937. This it determined to be $2,971,058.99. It then ascertained that the book cost of this same remaining property to the Ameri-

* The hearing Commissioner declined even to permit these briefs to be marked for identification (Tr., pp. 2189-2190).

can Company had been $2,487,083.16. It entered this latter sum in Account 100:1, *Telephone plant in service,* and recorded the $483,975.83, which represented the difference between the two sums in Account 100:4, *Telephone plant acquisition adjustment.* The appellee made no similar reclassification with respect to the instruments, for the reason that these were not deemed to constitute "a substantially complete telephone system, exchange, or toll line" within the meaning of §31.2-21 of the F. C. C.'s Uniform System of Accounts defining the category of acquisitions as to which the original cost method of accounting was made applicable.

If the F. C. C. had in fact been proceeding in the manner ~~now claimed, it would have~~ found that as to the toll plant, while the entry in Account 100:1, *Telephone plant in service,* correctly stated the book cost to the American Company of the plant remaining in service on January 1, 1937, there was a basis for a claim on its part that the amount entered by the appellee in Account 100:4, *Telephone plant acquisition adjustment,* was inadequate due to the failure to make any entry in Account 171, *Depreciation reserve.* If the F. C. C. had been proceeding along the lines now alleged, it might therefore have taken the position (indicated in the footnote on p. 14 of the Government's Brief) that the restatement of the accounts should have given recognition to "reserve rquirements" for the toll plant surviving as at January 1, 1937. On this view it might have determined appellee's reserve requirement and ordered a credit to Account 171, *Depreciation reserve,* in the amount so determined, with a corresponding increase in the amount to be recorded with respect to the surviving plant in Account 100:4, *Telephone plant acquisition adjustment.* Similarly, with respect to the instruments, if the appellee was wrong

in thinking that these did not constitute "a substantially complete telephone system, exchange, or toll line" within the meaning of the F. C. C.'s System of Accounts, the F. C. C., had it been proceeding on the basis now claimed, might have directed reclassification along similar lines of the balances as to the instruments remaining in service. In either case the Order would necessarily have been limited to the property still surviving.

If the F. C. C. had really been seeking to require a reclassification to conform with its own System of Accounts, its order would have differed from that actually made not only in this vital respect of being limited to surviving property but in another important respect as well.

The amount which the F. C. C.'s System of Accounts requires to be recorded in Account 100:4 is the difference between the amount of money actually paid for telephone plant and the cost of such plant to the original owner "less the amounts of reserve requirements for depreciation and amortization of the property acquired" (Instruction 31.100:4). The "reserve requirement" under straight-line depreciation accounting is the amount which should be in the reserve at a given time so that, when added to continuing accruals on the basis of the life and salvage then estimated, it will, if that life and salvage are exactly realized, equal the cost of the property less salvage at the end of its life.*

* Reserve requirement has been defined by the New York Public Service Commission (1939 Report, Vol. 1, p. 96) as being "the amount which should be in the reserve at a certain time in order that the continued application of the annual rates upon which the reserve was based would produce complete amortization of the cost within the remaining life of the property. In other words, it is the amount that should be in the reserve if straight line depreciation were correctly followed in all respects and if current anticipated life expectancies are realized."

The reserve requirements of the accounting company will, of course, vary from time to time, depending not only upon the age of the property but also upon current estimates as to length of its service life. These reserve requirements may be much greater or much less than the amounts set up for depreciation reserve on the books of the original owner at the time of sale. If the F. C. C. had any idea that it was requiring a reclassification under its own System of Accounts, it would scarcely have disregarded that System to the extent of basing its actions, not upon the reserve *requirements* of the accounting company at the date of the reclassification, as the System specified, but upon the actual *reserve* of the vendor at the time of sale.

Whatever results might have followed if the F. C. C. had proceeded to require a reclassification under its System of Accounts, it is thus clear that they would not have borne the slightest resemblance to what the F. C. C. has in fact ordered. With only an aggregate amount of $3,241,865.52 of the property purchased from the American Company (26% of the original total) remaining in the appellee's plant accounts as of December 31, 1941, the effective date of the Order, it would have been manifestly impossible for the F. C. C. to require entries *with respect to that property* which would have had the effect of placing in the adjustment account, 100:4, anything nearly as much as the $4,166,510.57 which it ordered appellee to charge to surplus. Certainly the Government cannot take the position that the credit of $3,879,957.94 to depreciation reserve, which the F. C. C. required as of that date, was needed to provide for the retirement of the actually *smaller* amount of property which was all that remained in the appellee's plant accounts.

The argument as to reclassification in Point II of the Government's Brief therefore does not show at all that the

Commission had power to make *this* Order. It shows merely that the Commission had power to make *an* order, and one very different from the order actually made.

**B. The Order cannot be sustained as requiring rectification of an alleged deficiency in appellee's depreciation reserve.**

To sustain the Order which the F. C. C. actually made, in contrast to a different one which it might have made, the sole remaining point advanced by the Government is (Point III of its Brief) that the F. C. C. was correcting a deficiency in the appellee's *depreciation reserve*. The claim is that the amounts which the appellee charged to depreciation were necessarily insufficient to provide for the retirement of the properties purchased from the American Company, and that, to the extent that the Order exceeds the limits permissible for an order reclassifying the balances in appellee's property accounts, it can be justified as requiring rectification of a deficiency in appellee's depreciation reserve.

The Government is totally unjustified in assuming, as it apparently does when it arrives at this point in its brief, that its case is won unless the appellee has some further arguments to advance. Except for an attempt in Point I of its brief to deal with appellee's contention with respect to the *A. T. & T.* case which is hereafter discussed (*infra*, pp. 54-60), all that has happened by the time the Government has reached Point III is that it has in effect confessed error with respect to the ground on which the F. C. C. actually based its Order, and has stated the conceded fact that the F. C. C. may require reclassification under its own System of Accounts of balances relating to property acquired in a transaction properly accounted for under a previous system. It has not answered and cannot answer

the demonstration just made that by its very nature the Order cannot be and does not purport to be such a reclassification. When we reach the Government's Point III, the basis on which the F. C. C.'s Order was made has been destroyed by the Government itself, and, quite apart from the doctrine of the *Chenery* case, *supra*, pp. 27-28, no other basis has been supplied to take its place. The contention as to depreciation accruals in Point III of the Government's Brief thus becomes the sole basis on which the Government's attempt to support the Order can rest.

This contention, of course, represents a complete departure from the claim of error in the original accounting, which constituted the basis of the order to show cause initiating this proceeding, of the entire hearing, and of the F. C. C.'s report. It has nothing whatever to do with the question of the purchase of property from an affiliate at more than the latter's net book cost. It equally has nothing to do with any question as to violation of the I. C. C.'s accounting rules. The issue has been transformed into one of proper depreciation accounting.

The new contention, as set forth in the Government's Brief (pp. 21-22, 41-51), is a purely theoretical one. It is a beautifully simple contention, as contentions unrelated to the facts usually are. It runs as follows: Part of the useful life of the property acquired by the appellee from the American Company had expired at the time of its acquisition. In spite of this, the appellee did not provide special (and higher) depreciation rates for this property but applied the same rates which it used for other property in the same class. This failure to provide special depreciation rates and the fact that the base on which accruals were made was not the original cost of the property but the amount paid by appellee to the American Company,

which was a price net after allowance for depreciation,* necessarily result, claims the Government, in a deficiency in appellee's depreciation reserve at least as great as the amounts by which the Commission's order requires the appellee to increase its depreciation reserve.

A brief outline of the nature and purpose of telephone company depreciation accounting, as this has been prescribed both by the I. C. C. and by the F. C. C., is itself sufficient to reveal the fallacies in the Government's argument. Instruction 23 of the I. C. C.'s Uniform System of Accounts, which in substance is continued in Instruction 31.02-80 of the F. C. C.'s Uniform System, prescribes that "the rate of depreciation should be fixed so as to distribute, as nearly as may be, evenly throughout the life of the depreciating property . . . . the cost of capital consumed in operations during a given month or year, and should be based upon the average life of the units comprised in the respective classes of property."

It must be obvious, in the first place, that "the average life of the units comprised in the respective classes of property" is a matter of judgment on which mathematical certainty is impossible. In the case of any company the charges made for depreciation and the resulting credits to the depreciation reserve are the results of many estimates of future life and future salvage. It is quite inconceivable that every one of these estimates should be precisely correct. Future events which affect the life of property cannot be exactly foreseen. One type of property will remain in service for a longer period than estimated, whereas the estimate made in the case of another type will prove too optimistic. This process of offsetting "one error by

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* This, of course, was required by the I. C. C. rules. See A., pp. 4-6.

another," at which the Commission and the Government profess to be shocked (R., p. 36; Government Brief, p. 49), is fundamental in depreciation accounting.

Secondly, it must be understood that the judgments which lie at the basis of a telephone company's depreciation rates are frequently revised. Depreciation rates are the subject of constant studies by the management, which take all relevant factors into account. These factors include not only the presence within the group of items acquired when a portion of their service life had already expired (Ex. 17 *id.;* Tr., pp. 392, 396) but also, and much more important, *differences in the service lives actually experienced from those originally estimated.* From time to time the rates are changed as the estimates of service life and salvage are changed. During the period since the acquisition of the property here in question from the American Company, there has been a strong general tendency toward a lengthening of service life and a consequent reduction in depreciation rates (Tr., p. 365; and see footnotes to pp. 48 and 49, *infra*).

Thirdly, it should be noted that, as indicated above (pp. 11-12, *supra*), a telephone company does not make any attempt to set up for each particular unit of property a reserve adequate to provide for the retirement of that unit. On the contrary, as required both by the I. C. C. (Uniform System of Accounts for Telephone Companies, First Issue, Instruction 23) and by the F. C. C. (Uniform System of Accounts for Telephone Companies, Instruction 31.02-80), the appellee employed the "group method" of depreciation accounting. Since the Government's contention in this case hinges upon applying to group depreciation accounting considerations that would be applicable, if at all, only to unit depreciation accounting, it is desirable to explain the fundamental difference between these two methods.

Under the unit method, each unit of property is separately treated in the depreciation accounts. Suppose, for example, that a company acquires 100 units of a particular kind of property which are determined to have an average service life of twenty years and no salvage. Under the unit method, depreciation would be accrued at the rate of 5% per annum against each unit separately. If a particular unit were retired at the end of ten years, the depreciation reserve would be charged only with the amount (50% of the cost of this particular unit) which had been credited to the reserve on account of this unit during these ten years, and the remaining 50% of the cost of the particular unit would be charged at the time of retirement to operating expenses. On the other hand, at the end of the twenty years all depreciation charges would cease for any of the units included in this purchase, no matter how long they continued thereafter to be in service.

On the other hand, under the group method, which has been required in the telephone industry, taking the same illustration, the 100 units would be considered as a group. Annual charges to depreciation would be made at the rate of 5% of the original book cost of all those units which were still in service. If one unit was retired at the end of ten years, the depreciation reserve would be charged with 100% of the book cost of that unit, *although obviously the portion of the depreciation reserve which had been built up by accruals related to that particular unit would amount to only 50% of its book cost.* On the other hand, depreciation charges would continue on as many units as remained in service even after the twenty-year estimated average service life had expired. See *Depreciation Charges of Telephone Companies,* 118 I. C. C. 295, 367 (1926). Under such a method, it would obviously be absurd to say that the company had made insufficient provision for the retirement

of the units which went out of service at the end of ten years, and excessive provision for those which remained in service after twenty years. For the whole basis of the group method of depreciation accounting is that inequalities of this sort are averaged in the rate fixed for the group as a whole.

Finally, it is to be noted that a telephone company has only a single depreciation reserve and not a separate reserve for each class of plant, much less for each unit. The depreciation reserve is "a single composite reserve" to which all depreciation expense charges are credited and against which all retirements are charged.*

With this background, let us now turn to the Government's contention of a deficiency in appellee's depreciation reserve resulting from these purchases.

The issue which this contention raises is an issue, not of correct accounting, but of fact. Yet the Government attempts to resolve it on the basis of pure theory without any inquiry into what the facts actually were. The Government repeatedly *asserts*, in one form or another, that "when the property reached the end of its service life, insufficient amounts had been accumulated in appellee's depreciation reserve to cover the cost of the property as carried in appellee's plant accounts" (Government Brief, p. 22). Yet the record contains no evidence as to what amounts had been accumulated in the depreciation reserve, and efforts on the part of the appellee to show that sufficient amounts had been accumulated were blocked at the hearing.

A contention of inadequate depreciation accruals might conceivably mean any one of three different things. It might mean that appellee's depreciation reserve was insufficient as a whole. A second meaning would be that the portion of the depreciation reserve which had been built up by

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* See Account 102 of I. C. C.'s 1933 System of Accounts and Instructions 31.171 of the F. C. C.'s System, A., pp. 9-10, 13-14.

accruals with respect to those *classes* of property in which the acquisitions from the American Company were included was inadequate to take care of past retirements and leave a reserve sufficient to meet the reserve requirements for these classes. And a third meaning would be that the accruals in respect of the *particular units of plant* acquired from the American Company were insufficient to provide for past retirements of those units and leave a balance sufficient to meet reserve requirements for such of those units as had not yet been retired.

We shall consider each of these possibilities.

(1) The first of these possible meanings, namely, that the depreciation reserve is inadequate as a whole, is not urged by the Government. The Commission itself conceded in its report (R., p. 36):

> "No challenge is here being made to the adequacy of the depreciation reserve as a whole."

Moreover, the appellee offered, and the Commission excluded, an exhibit (Ex. 65 *id.*, Tr., pp. 1322, 1326) showing that appellee's depreciation reserve fully met its reserve requirements.

Actually this concession by the Commission should have ended the entire argument. The only basis on which a company can be required to make a transfer on its balance sheet from surplus to another liability account, in this case depreciation reserve, is that its liabilities (other than surplus) have been understated. Since under the F. C. C.'s own rules (A., p. 14) the depreciation reserve is a "single composite reserve" and since no other liability account is questioned, the Commission's concession of adequacy of the reserve is wholly inconsistent with its order that nearly $4,000,000 be transferred from surplus to it.

(2) An attempt to support the Order on the basis that the portion of appellee's depreciation reserve which had been built up by accruals with respect to the *classes* of property in which the acquisitions from the American Company were included was inadequate to take care of past retirements and leave a reserve sufficient to meet the reserve requirements for these classes of property, must likewise fail. There is no evidence to support such a claim, and if the claim could be supported, it would be irrelevant.

(a) The Commission did not place in the record any studies as to the amount of property included in the various classes into which the property purchased from the American Company fell, the depreciation rates that were used from time to time, the retirements that were charged, the salvage that was realized, the present balances in these accounts, the reserve requirements, or the amount of the "single composite reserve". In fact, the F. C. C. excluded an exhibit offered by the appellee (Ex. 65 *id.*, Tr., pp. 1322, 1326) showing the reserve requirements for each class of property and the adequacy of the "single composite reserve" to meet them. The theoretical argument on which the F. C. C. relies would apply at best to the *initial* depreciation rates, and then only to the particular units of property purchased from the American Company which, in general, comprised a relatively small portion of each class.

Moreover, there was evidence, received or tendered, showing that the effect of the purchase of going or completed plant *was* considered by appellee's management in fixing rates of depreciation for the various classes of its property. The appellee offered in evidence instructions from its chief accounting officer that "a large purchase of going or completed plant might introduce such important changes in

the average service life, book cost and salvage value of the total property as to necessitate a general revision of the depreciation rates, although it does not seem probable that such a situation will arise in the New York Telephone Company", and that "in any revision of depreciation rates the effect of past and prospective purchases of going or completed plant should, of course, be given proper consideration." (Ex. 17 *id.;* Tr. 392, 396). While the Commission refused to admit this evidence, the appellee was fortunate in having the testimony of a witness, actively concerned in these very transactions of many years past, who testified specifically with respect to the toll plant acquired from the American Company (Tr., p. 365) that "we discussed with the engineers the question of the effect of this purchase on the depreciation rates, and whether or not the depreciation rates should be increased to allow for the fact that the property purchased was not new and, therefore, had less than the full life remaining", and that it was determined that such an increase was unnecessary because "there were certain other factors that were operating to extend the life of the property in almost all of the accounts which more than offset the shortening of life in a few accounts that resulted from this purchase".*

* The full text of Mr. Trax's testimony, which is reproduced in the Appendix to this brief (A., pp. 15-20), shows that it related specifically to the question whether this *particular* purchase called for changes in depreciation rates. This testimony was in no way affected by the testimony of the two other witnesses, Messrs. Bradshaw and Schaffer, referred to by the Government on pp. 47-48. Mr. Bradshaw's testimony that the rates applied to the toll plant purchased from the American Company were the same rates previously determined, was entirely consistent with Mr. Trax's testimony that these previously determined rates were considered adequate *after* the purchase because "there were certain other factors that were operating to extend the life of the property in almost all of the accounts which more than offset the shortening of life in a few accounts that resulted from these purchases". Mr. Schaffer's testimony dealt with general questions of accounting theory and had no relationship to any particular depreciation rates.

(b) Not only was there no evidence of a deficiency in depreciation reserve for these particular classes of property, but the record contains specific and uncontradicted expert accounting evidence that even if such a deficiency existed, it would be of no moment if it was offset by an excessive provision for some other class. Mr. M. F. Orton, Director of Research and Valuation for the New York Public Service Commission, testified that a failure to provide sufficient in the reserve for certain classes of property would not justify an order reducing surplus when such a deficiency was counterbalanced by an excess for other classes (A., pp. 25-26). So long as a telephone company has made adequate charges for depreciation against its gross revenues, reducing, to that extent, the amount otherwise available for surplus, the public cannot fairly or lawfully demand that the company reduce surplus a second time simply because it has charged too much for one class of property and too little for another.

(3) The Government's real reliance appears to be on the claim that the amounts accrued in respect of the *particular units* of property purchased from the American Company were not sufficient to take care of past retirements and leave a reserve adequate for the balances remaining on the books. Here again, there are two answers, either of which would be sufficient. There is no evidence to establish the claim, and if the claim were established, it would be irrelevant.

(a) There are no facts to bear out the Government's contention. There is simply nothing in the record as to the portion of appellee's depreciation reserve resulting from accruals made in respect of the property purchased from the American Company, or as to the relationship between accruals, retirements, salvage, present balances and

reserve requirements. The absence of such evidence is, of course, the strongest possible indication that no such claim as that now advanced by the Government was urged before the Commission. The Government's argument is simply an attempt to substitute theory for fact.

Moreover, even as a theoretical argument, and even if it were permissible to look only at the units of property acquired from the American Company (which it is not since telephone companies are not permitted to practice unit depreciation accounting), the Government's argument would be unsound. For it concerns itself solely with the initial depreciation rates and ignores the effect of increased length of service life and related changes in depreciation rates, and of decisions, on this very ground of purchases of going or completed plant, to refrain from making reductions in rates that otherwise would have been made.*

The effect of increased length of service life can be illustrated by the very case put in the footnote to page 44 of the Government's Brief. In this case property having an original cost of $80 and an *estimated* service life of ten years (with no salvage) was acquired for $70 when it was three years old, and the purchasing company applied the same 10% depreciation rate which it applied to property that had been acquired new. The Government says there

* The Government constantly endeavors to center the Court's attention on the depreciation rates initially established, ignoring the effect of the numerous changes made over the years. Thus it states (Government Brief, p. 44) that "The annual depreciation rates which appellee applied thereafter were those which had previously been determined with respect to the property of the class in question * * *". This statement is decidedly misleading unless it is limited to the rates applied *immediately* after the acquisitions. The record made it clear that, both as to the toll plant and as to the instruments, depreciation rates were periodically revised and changed over the entire period up to the effective date of the F. C. C.'s Order (Tr., pp. 365-366, 1016-1017, 1038-1039, 1141, 1313).

would inevitably be a deficit of $21 [*i. e.*, $70—(7 x $7)] in the depreciation reserve. However, if the property *actually* remained in service not for the ten years originally estimated but for thirteen years, and no change was made in depreciation rates, the accruals resulting from application of the 10% rate would be precisely adequate *even in the case of these particular units.* This is enough to show that mere theorizing on this subject, such as that indulged in by the Government, cannot serve as a substitute for the facts. Throughout the period since these acquisitions the tendency was toward precisely this lengthening of service life, the trend of depreciation rates was downward, and even the decreases in depreciation rates which were made by appellee were not deemed sufficient by the New York Public Service Commission (Tr., p. 1141)*.

(b) However, even if there were evidence and not mere theoretical argument that the depreciation accruals in respect of these particular items of property would not be adequate for their retirement, this fact would still be irrelevant. The general point indicated above (pp. 40, 47), namely, that inadequate accruals in respect of one type of property are without significance if they have been counterbalanced by excessive accruals in respect of another type, applies again here. But a further and conclusive reason is that under the group method of depreciation accounting, no *attempt* is made to provide a reserve adequate for the retirement of *any unit* of property, the whole basis of the method being that the amounts accrued will prove inadequate in the case of some units and excessive in the case of others. The depreciation rate for each class is based on the average life of *all the units* in the class. Expectation of shorter than normal lives for particular units is taken into

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* P. U. R. 1930C, 325, 351, and 14 P. U. R. (N. S.) 443, 450-451 (R., pp. 13-14).

account in fixing the average rate applied to all units, not by fixing special rates to be applied to particular units.*

The Government's argument on this entire subject simply begs the question. It claims (Government Brief, p. 49) that appellee's argument is "that the mere fact that it debited its depreciation reserve with more than it had credited thereto is not controlling unless it can be shown that the depreciation reserve as a whole is inadequate," something which it characterizes as a "novel doctrine." The proposition that when an administrative commission seeks to go beyond a reclassification of the accounts with respect to property still on the books and require a further charge to surplus on the basis of asserted inadequacy in the depreciation reserve, it must establish that the reserve is, in fact, inadequate, would not seem such "a novel doctrine" as the Government thinks; but the complete answer is that there is no proof whatever that appellee did "debit its depreciation reserve with more than it had credited thereto". In fact, there is a total absence of evidence as to what either the debits or the credits were, either in detail or even in total.

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* We can perhaps clarify this point with the same hypothetical case given on p. 44 of the Government's Brief. Suppose the American Company acquired $80 of new property having an estimated life of ten years and no salvage, kept the property for three years and then sold it to appellee for $70. Suppose that at the same time appellee had $35 of new property of the same class. Under the system of special depreciation rates on partly used property now advocated by the Government, the company would have to apply to the used property a rate of 14-2/7% so as to retire it in seven years, while it would apply to the property acquired new a rate of 10%, this providing the amount necessary to retire this property at the end of ten years. However, precisely the same depreciation accruals would be provided by applying to *all* of the property a rate of 12.5% under the original estimate of a ten-year life, or by application of the 10% rate if the property had an actual service life of twelve years instead of the ten originally estimated. The application of an average rate to all of the property was the type of depreciation accounting required by the group method prescribed by the I. C. C. and F. C. C. accounting rules and followed by the appellee.

The Government's contention really boils down to a claim that where used property has been acquired, a company's depreciation reserve is *necessarily* inadequate unless special depreciation rates for this particular property have been provided. But neither the I. C. C. nor the F. C. C. System of Accounts requires or even contains any provision for the use of such rates, and the argument completely neglects the effect of changes in service lives and depreciation rates, the group method of depreciation accounting, and the uncontradicted testimony that an inadequate accrual even in respect of an entire class of property would not justify a charge to surplus if this inadequacy was counterbalanced by an excess in respect of some other group.

Our argument here is not, as the Government would have the Court believe (Government Brief, pp. 49-50), that "when the Commission discovers that there is an error in an entry made by a carrier in its depreciation reserve account, the Commission is powerless to require the correction of this error unless it can find that the depreciation reserve as a whole is incorrect." We do not contend that where there is evidence of an "error in an entry made by a carrier in its depreciation reserve account," *e.g.*, a failure to make any charge to depreciation expense for depreciable property or where, as in the case put by the Government (Brief, p. 50), a company has made a completely unauthorized transfer from depreciation reserve to surplus, the Commission may not require that error to be corrected without inquiring whether the depreciation reserve as a whole is adequate. Here, however, there was no evidence of "an error in an entry made by a carrier in its depreciation reserve account." If a company is to be forced to make additions to its depreciation reserve *on the ground that the*

*reserve is inadequate,* which is something quite different, the Government must prove such inadequacy as a fact. A commission seeking to make a company's depreciation reserve conform to the facts of today cannot lawfully proceed by considering only factors tending to make the reserve inadequate and denying the company the right to show that these have been offset by factors tending to make the reserve excessive. To do so could only result in making the reserve *not* conform to the facts and in forcing the company to misrepresent its financial situation.

The Government can derive no comfort from the provision of Section 220(c) of the Communications Act that "The burden of proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing, or requiring such entry * * *."

The F. C. C.'s order to show cause (R., pp. 47-49) did not call into question any specific entry making a charge to depreciation expense or a debit to the depreciation reserve. It did question the original accounting entries, which have been demonstrated to be correct. No claim was made in the proceedings before the Commission that any order going beyond reclassification of the balances as to the surviving property could be made unless the original accounting was shown to be erroneous.

Appellee's charges to depreciation expense and the credits to depreciation reserve, supposed errors in which are now urged as the basis of the Commission's Order, not only are not mentioned in the order to show cause (R., pp. 47-49) but do not even appear in the record. In the entire course of the proceedings, the Commission raised no question as to any "accounting entry" either to depreciation expense or to depreciation reserve. The only point

with respect to depreciation ever made in the proceedings before the Commission was the contention that appellee should have established special depreciation rates to provide for retiring the particular units of plant acquired by it from the American Company, and that contention has been fully answered (pp. 43-51, *supra*).

The plain facts of the matter are not only that there is no evidence to show an inadequacy in appellee's depreciation accruals, but that to require appellee to charge surplus in order to add $3,879,957.94 to its already adequate depreciation reserve would require appellee to charge its surplus twice. All credits to depreciation reserve, whether in the form of annual charges for depreciation or special transfers from the surplus account, have the effect of making surplus less than it otherwise would be. The Government, in effect, concedes (Government Brief, p. 42) that if the appellee had adopted special depreciation rates designed to provide for the retirement of this particular property at the end of its service life, the F. C. C.'s Order would require a double charge to surplus and would be improper. Yet, as a matter of substance, this is precisely what the present Order does. For the appellee offered to prove the entire adequacy of its depreciation reserve (Ex. 65 *id.;* Tr., pp. 1322, 1326), and adduced specific and uncontradicted testimony that its acquisitions of going or completed plant were taken into consideration in the periodic revisions of depreciation rates (Tr., pp. 365-366).

What the F. C. C. has ordered here would thus not merely place the appellee in the position that it would have been in if its original accounting had conformed with the views of the F. C. C. rather than the requirements of the

I. C. C., but in a very much worse position. The Government's talk of inadequacy in the depreciation reserve is only a form of words designed to conceal that the Commission's real endeavor was completely to revise the initial accounting, ignoring all that has happened in the years between. It is in that sense, and not in the sense of any claim by appellee to a vested right in accounting rules or particular book entries, that this case involves "retroactive accounting" and makes applicable this Court's recent statement, *Claridge Apartments Co.* v. *Commissioner of Internal Revenue*, 323 U. S. 141, 164 (1944), that:

> "Retroactivity, even where permissible, is not favored, except upon the clearest mandate. It is the normal and usual function of legislation to discriminate between closed transactions and future ones or others pending but not completed."

The same salutary principle applies to administrative action. Compare *Morgan* v. *United States*, 304 U. S. 1, 15 (1938).

## POINT III.

**The Commission's Order constitutes a flagrant violation of the "binding construction" of the Federal Communications Commission's Uniform System of Accounts made in *American Telephone & Telegraph Company* v. *United States*, and the District Court would have been justified in enjoining it upon this ground alone.**

We have shown in Points I and II that the injunction granted by the District Court would have been properly issued even if there had been no prior legal proceedings between these parties with respect to the subject-matter

of this litigation. However, that is not the situation here, and the judgment of the District Court should be affirmed on the independent ground that the Order violates the "binding construction" of the F. C. C.'s System of Accounts filed pursuant to this Court's request in the *A. T. & T.* case. As was said in the opinion of the District Court (R., p. 117):

> "The administrative construction referred to, and plainly appearing in the stipulation then filed by the counsel for the Federal Communications Commission, is not present in any of the other cases to which our attention has been called; and this case, for that reason, if for no other, is clearly to be distinguished from those cited. That administrative construction, if none other, it seems to us, precludes the action now taken until (1) there has been a 'fair consideration of all the circumstances,' and (2) unless the difference between the original and present cost is not 'a true increment of value' but is a 'fictitious or paper increment;' and action to obliterate must depend upon 'evidentiary circumstances' later to be developed."

The situation presented by this case is precisely the situation which the "binding construction" required of the F. C. C. in the *A. T. & T.* case was meant to meet. In its opinion in the *A. T. & T.* case, this Court refers (299 U. S. at 240) to the fear on the part of the telephone companies that the Commission, without further consideration, would require the writing off to surplus of all amounts representing the excess of purchase price over the seller's original cost which the Commission was requiring to be recorded in Account 100.4. This Court held (299 U. S. at 240) that if the F. C. C.'s System of Accounts "had the meaning thus imputed to it, there would be

force in the contention that the effect of the order is to distort in an arbitrary fashion the value of the assets." But, the Court said, this is not what the F. C. C.'s System of Accounts means, and the contrary had been made clear by testimony of the Commission's chief accountant and by the argument of Government counsel at the bar. Then follows the statement that "To avoid the chance of misunderstanding and to give adequate assurance to the companies as to the practice to be followed, we requested the Assistant Attorney-General to reduce his statements in that regard to writing in behalf of the Commission" (299 U. S. at 241).

As a result of this request, there was filed the declaration (R., p. 46) which this Court accepted "as an administrative construction binding upon the Commission in its future dealings with the companies." This declaration stated that amounts included in Account 100:4 representing sums paid by a telephone company for properties acquired from another in excess of the latter's original cost less reserve requirements were not to be written off to surplus if these amounts "are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value," and that when amounts so included "are deemed, after a fair consideration of all the circumstances, to be definitely attributable to depreciable telephone plant, provision will be made for amortization of such amounts through operating expenses, * * *"

In contrast with this fair promise as to the interpretation of its System of Accounts made by the F. C. C. in order to avoid the injunction threatened in the *A. T. & T.* case, that Commission, in the first case in which the application of these features of its System has come in issue,

now proceeds in complete defiance of the "binding construction." It orders the write-off of the entire excess of the purchase price of the property here involved over the American Company's net book cost, although, as found by the District Court, (R., p. 122), it "made no determination with respect to the value of any of the property purchased by the plaintiff from the American Company and counsel for the defendants in this action, upon oral argument, informed the Court that the Commission was not relying on any claim of overvaluation and that for the purposes of this action no such issue existed."

The F. C. C.'s report (R., p. 36) shows that the Commission was not without embarrassment on the score of the "binding construction." It overcame that embarrassment primarily by relying on the theory that the *original entries* were in error. This flanking maneuver permitted the Commission to argue that the only part played by its own Uniform System of Accounts was "to call attention to an impropriety in accounts which should have been corrected even if the new system had not gone into effect" (R., p. 36), and that consequently the "binding construction" of that System did not come into play. Insofar as the Commission's attempted escape from the "binding construction" was founded on this basis, the effort must necessarily fail, for the reasons set forth in Point I of this brief.

The Government, in fact, now makes no attempt to support the departure from the "binding construction" on this basis of error in the original accounting. Its position is rather that where the vendor is an affiliated company, an excess of purchase price over the vendor's net book cost *cannot* represent an investment in an asset of continuing value or be "definitely attributable to depre-

ciable telephone plant", whatever the actual facts may be, and that no further inquiry can or should be made. Judge Swan made the appropriate comment on this argument when he said in the District Court that on any such view the "binding construction" in the *A. T. & T.* case "was a very tricky stipulation," indeed.*

There is not a word either in the "binding construction" in the *A. T. & T.* case or in Mr. Justice Cardozo's opinion which gives any support to the view now urged that consideration of the single fact that assets were purchased from an affiliated company and simultaneous refusal to look at any other facts constitute the "fair consideration of all the circumstances" which the Government promised. Obviously such an "interpretation" of the stipulation is the exact equivalent of saying that whenever property is purchased from an affiliate, the stipulation has no application at all. There is nothing in the language of the stipulation

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* We quote the following from the oral argument in the District Court:

"Judge Swan: And did you make a fair consideration of all the circumstances?

"Mr. Plotkin [Counsel for the F. C. C. and the United States]: Yes. Suppose that these amounts had been put on the books as a result of a straight write-up, the only thing we would look into is not whether at the time of the write-up the property had that value but whether it had been the result of a straight write-up. If that had occurred we would have required that to be eliminated.

"Judge Bright: When that stipulation was made in the A. T. & T. case, you were dealing with dealings between the A. T. & T. and its affiliates, weren't you?

"Mr. Plotkin: There were many such dealings involved.

"Judge Bright: *If that were so, wouldn't the words 'fair consideration of the circumstances' refer to something else than the mere fact of affiliation?*

"Mr. Plotkin: While it is true today that the A. T. & T. controls a substantial part of the telephone business, and while it has been true that it controlled throughout the——

"Judge Swan: *I would say that was a very tricky stipulation.* Perhaps you are right; perhaps we can't hold you to anything else——." (Italics supplied.)

which remotely suggests this, and the record and this Court's opinion in the *A. T. & T.* case make it clear that all parties were fully aware that the bulk of the purchases that would be affected by the "original cost" requirements imposed by the F. C. C.'s System of Accounts were precisely of this type.

The telephone companies understood the "binding construction" in the *A. T. & T.* case to mean that the F. C. C. would look into all the facts and circumstances and not merely at one of them. They recognized, of course, that if in any case asset accounts contained entries where no property had, in fact, been received, as in *Northwestern Electric Co.* v. *Federal Power Comm.*, 321 U. S. 119 (1944), amounts represented by such entries would not be permitted to remain. They realized also that if amounts paid for physical plant exceeded the fair value of the plant so acquired, these amounts likewise would be required to be written off. But both the language of the stipulation and the circumstances which led to its being made gave them the fullest assurance that where, as here, physical property had been acquired at a price believed by the parties to represent its fair market value at the time, the accounting company would be given an opportunity to substantiate that fact and would not be met by the argument that *under no circumstances* can a payment to an affiliated company in excess of the latter's net book cost be deemed to constitute an investment "in assets of continuing value" or to be "definitely attributable to depreciable telephone plant."

The Government talks (p. 29) of the possibility of property being transferred from one corporation to another for the purpose of swelling surplus. Where this is shown, a commission might well be justified in refusing to go farther into the facts. But what application does all this have to transactions such as these, concededly entered into for

a proper business purpose and handled on the very basis prescribed by the Federal administrative agency then in control?

If this Court had exacted from a private litigant any such stipulation as that made by the Government in the *A. T. & T.* case, it is unthinkable that it would permit the stipulation to be evaded on any such flimsy pretext as that which the Government has advanced here. Surely, the Court will not require a lesser standard of conduct from agencies of Government which must accredit themselves "by acting in accordance with the cherished judicial tradition embodying the basic concepts of fair play." *Morgan v. United States, supra,* at p. 22.

## Conclusion.

The District Court was right in sending this Order back to the F. C. C. for further consideration.

The Order cannot be sustained as one reclassifying the balances in appellee's property accounts to conform to the Commission's System of "original cost" accounting, since nearly three-fourths of this property has already been written off the books and since the Order does not even purport to follow the new System of Accounts. The F. C. C. sought to sustain its action by the theory, which is shot through its report, that the appellee was guilty of an error in the original accounting which the F. C. C. might now correct. That theory being demolished, the Order necessarily falls with it. It is not for the courts to attempt to patch up the Order on the basis of a merely theoretical argument as to inadequacy of depreciation reserve, and a wholly unsound one at that, when no such issue was raised by the F. C. C.'s order initiating this proceeding and the record is devoid of any factual evidence to support the

claim. Beyond this, the Court should not permit the stipulation which it exacted in the *A. T. & T.* case to be flouted as the F. C. C. has done here.

Whatever order the F. C. C. may be in a position to make, it far exceeded its powers when it made the Order here under review.

**The judgment of the court below should be affirmed.**

Respectfully submitted,

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